

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

DISCOVER FINANCIAL SERVICES NSA

Docket No. MC2015-3

DISCOVER FINANCIAL SERVICES NSA

Docket No. R2015-2

**RESPONSES OF THE UNITED STATES POSTAL SERVICE TO
COMMISSION'S INFORMATION REQUEST NO. 1, QUESTIONS 1-18**
(December 19, 2014)

The United States Postal Service ("Postal Service") hereby provides its response to the Postal Regulatory Commission's Information Request ("CIR") No. 1, Questions 1-18. CIR No. 1 was issued December 12, 2014. The Postal Service's responses were due by December 19, 2014. Each question contained in CIR No. 1 is reprinted verbatim and is followed by the Postal Service's corresponding response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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QUESTION 1: In its review of the Postal Service's Request, if the Commission cannot find that the Agreement "improve[s] the net financial position of the Postal Service through . . . increasing the overall contribution to the institutional costs of the Postal Service," the Commission may also approve the Agreement if it "improve[s] the net financial position of the Postal Service through reducing Postal Service costs." 39 U.S.C. § 3622(c)(10)(A)(i) (emphasis added). Please describe how the Agreement may reduce costs to the Postal Service. If it is anticipated the Agreement will have no effect on costs to the Postal Service, please confirm.

RESPONSE 1: The Postal Service hereby confirms that we anticipate the Agreement¹ will have no effect on costs to the Postal Service.

¹ Notice of the United States Postal Service of Filing Request to Add Discover Financial Services Negotiated Service Agreement to the Market-Dominant Product List, 10/27/2014, Docket MC2015-3, R2015-2 (Filing ID 90545), available at [http://prc.gov/Docs/90/90545/DFS%20Filing%20\(FINAL\).pdf](http://prc.gov/Docs/90/90545/DFS%20Filing%20(FINAL).pdf).

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QUESTION 2: In its review of the Postal Service's Request, if the Commission cannot find that the Agreement "improve[s] the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service," under section 3622(c)(10)(A)(i), see *also* C.F.R. § 3010.42(f), the Commission may also approve the Agreement on an alternative ground if it "enhance[s] the performance of mail preparation, processing, transportation, or other functions" under section 3622(c)(10)(A)(ii) (emphasis added); see *also* 39 C.F.R. § 3010.42(g). In its response to Chairman's Information Request No. 1,² question 4, the Postal Service states that it "does not anticipate further performance enhancements relating to mail preparation, processing, transportation as virtually all of Discover's mail is full-service Intelligent Mail barcoded ("IMb")." Please describe the Postal Service's view of what "other functions" are enhanced through the proposed Agreement. If the Agreement will have no effect on "other functions" of the Postal Service, please confirm.

RESPONSE 2: The Postal Service hereby confirms that we anticipate the Agreement will have no effect on "other functions" of the Postal Service.

² Responses of the United States Postal Service to Chairman's Information Request No. 1, questions 1-12, November 13, 2014 (CHIR Response).

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QUESTION 3: The Postal Service states that “this NSA will drive accelerated growth in DFS Eligible Mail and has the potential to impact the trajectory of First Class Mail and Standard Mail among other financial services industry mailers.” Request at 5. Yet, the Postal Service also states that it “expects that the contribution from mailers not party to the NSA will not change as a result of this Agreement; thus, no analysis was provided.” CHIR Response at 17. Please reconcile these statements. If the Postal Service does expect the Agreement to induce other financial service mailers to increase volume, please provide the basis for this expectation.

RESPONSE 3: The responses referenced above are consistent and readily reconciled thusly: in the event a similarly situated financial services industry mailer enters into a substantially similar Negotiated Service Agreement (“NSA”) as the one by and between Discover Financial Services (“DFS” or “Discover”) and the Postal Service, the Postal Service expects it would induce other financial service mailers to increase volume. Absent such NSAs by and between the Postal Service and similarly situated financial service mailers, the Postal Service does not expect the Agreement to induce other financial service mailers to increase volume. Furthermore, if similarly situated mailers seek similar deals, the Postal Service should see greater aggregate institutional cost contribution as the Postal Service would preserve contribution from similarly situated large mailers who elect to remain in the mail instead of seeing the escalating migration of marketing funds from mail to digital channels.

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QUESTION 4: The Postal Service states that the Commission should:

Wait for real evidence of the merits of the deal in the event rebates are provided[.] If that evidence does prove that this NSA failed to provide any financial benefits, the Postal [S]ervice would have no incentive to continue it, and, under the terms of the contract, it could terminate.

Response of the United States Postal Service to Comments of the Public Representative, November 21, 2014, at 6 (Response to PR). Please confirm that the Postal Service intends to terminate this Agreement before or during contract year 2 if the Agreement fails to reduce Postal Service costs or increase the overall contribution to the institutional costs of the Postal Service (using the accepted methodology). If not confirmed, please explain.

RESPONSE 4: In the event the Agreement fails to provide the anticipated financial benefits, the appropriate senior Postal Service management would be informed of all relevant considerations, including the statutory basis for the Postal Service authority to adopt particularized pricing agreements with mailers, the financial effects of the particular agreement in question, and any other relevant factors (e.g., the risk of Discover and other mailers diverting funds from mail to digital media). As a practical matter, the decision to terminate an existing NSA would rest primarily with senior Postal Service management. The Postal Service expects that, if senior Postal Service management concludes that the Agreement failed to reduce costs or increase contribution, it would lead to a decision to terminate the contract.

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QUESTION 5: Please refer to CHIR Response, question 2.4 at 5. Please provide a detailed, step-by-step explanation of the Postal Service's "net value method" and "quantitative analytical methodology." Please explain how the Postal Service's "net value method" and "quantitative analytical methodology" are an improvement over the accepted methodology.

RESPONSE 5: As noted in prior filings by Discover, the methodologies employed by the Postal Service are mailer and transaction specific, whereas the Commission's preferred methodology employs aggregated information which does not reflect the way any individual company behaves.³ Similarly, the data on which the Postal Service rely are mailer-specific. In the context of negotiations with individual mailers to conclude particularized pricing agreements, the Postal Service believes that mailer-specific information is a more reliable guide for its business judgment to establish NSAs. Detailed explanations of the Postal Service's "net value method" and "quantitative analytical methodology" are as follows:

- a. Actual volumes mailed above the Before Rates trend are calculated.
- b. Contribution on these volumes is determined based on the published contribution per mail category.
- c. Any rebate paid to the mailer is deducted from this calculation.
- d. The result is the Net Value of the NSA year.

³ Motion for Acceptance of Discover Reply Comments, 11/21/14, Docket MC2015-3, R2015-2 (Filing ID 90710), available at <http://www.prc.gov/Docs/90/90710/Motion%20for%20Acceptance%20.pdf>. See also Reply Comments of Discover Financial Services, 11/21/14, Docket MC2015-3, R2015-2 (Filing ID 90711),

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QUESTION 6: Please describe the financial risks to the Postal Service if the volume projections provided by Discover and used in the Postal Service's workpapers supporting the Request are either substantially higher or lower than originally projected.

RESPONSE 6:

Please be advised that the current projected after-rates volumes are the negotiated minimum volumes required to achieve the threshold and represent the annualized projected growth to which Discover was comfortable committing. In the event the volume projections provided by Discover (i.e., after-rates volumes) are substantially higher than originally projected, subsequent new incremental volume will increase as after-rates volume is higher than volume absent an agreement (i.e., before-rates volume). There is no financial risk to the Postal Service. If approved by the Commission, the NSA would result in new higher contribution due to increased incremental volume.

In the event the volume projections provided by Discover (after-rates volumes) are substantially lower, there is still no financial risk to the Postal Service; however, subsequent new incremental volume and contribution would be lower. In the event after-rates volumes are lower than the contractual threshold, no financial risk will be realized as Discover would simply continue to mail at published rates.

available at <http://www.prc.gov/Docs/90/90714/Reply%20Comments%20112114.pdf> [Collectively hereinafter, "DFS Reply Comments"].

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As Discover is a leading innovator in the financial services industry, the impact of Discover shifting out of mail to solely digital channels would likely have a ripple effect throughout the financial services industry. In the event Discover's aggregate mail volume increases, there is no risk to the Postal Service as the aggregate contribution (after payment of the discount) would exceed the amount of the discount.

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QUESTION 7: Other than the volume projections provided by Discover, please provide and describe the evidence the Postal Service relies upon to state that the Postal Service's revenue attributable to Discover will decline absent the Agreement.

RESPONSE 7: The Postal Service relied upon statements made and materials shown by Discover's representatives to Postal Service representatives during the course of negotiations indicating that Discover would divert marketing spend from mail to digital channels. This material included marketing metrics reflecting use of digital channels by Discover overtaking mail. This information was a key factor in the Postal Service's decision to enter into negotiations with Discover. As noted in Harit Talwar's statement⁴ and in Discover's reply comments,⁵ the Agreement kept Discover in the mail. Thus, absent the Agreement with Discover, the Postal Service would lose revenue otherwise attributable to Discover. Discover did not provide us with volume projections reflecting the absence of an NSA. In the absence of an NSA, it would be difficult for any NSA partner to predict volumes. To determine whether volume and/or revenue are likely to decline (if evident in the data) in the absence of an NSA, the Postal Service relies on an analysis of company and related industry-specific historical volume trends extrapolated

⁴Id.

⁵ Notice of Filing of Statement of Harit Talwar, Chief Marketing Officer of Discover Financial Services, 10/28/2014 (Filing ID: 90559), *available at* <http://www.prc.gov/Docs/90/90559/Notice%20DFS%20Talwar%20Statement.pdf>. See also Statement of Harit Talwar, Discover Financial Service Executive Vice President, President –U.S. Cards, and Chief Marketing Officer, 10/28/2014, Docket MC2015-3, R2015-2 (Filing ID 90560), *available at* <http://www.prc.gov/Docs/90/90560/Statement%20of%20Harit%20Talwar%20.pdf>. [Collectively hereinafter, "Talwar Statement"].

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over the period of an NSA. That material is provided under seal as USPS- MC2015-
3/NP1

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QUESTION 8: In its response to the Public Representative's comments, the Postal Service states that it would prefer the Public Representative's second option (*i.e.*, conditionally approve the Agreement and order the Postal Service to petition for a rulemaking) to the Public Representative's first option. Response to PR at 6. Please provide a proposed duration for the Agreement under any conditional approval and a proposed timeline for the rulemaking docket the Postal Service would file.

RESPONSE 8: Although conditional approval by the Commission is a better option than the Commission not granting its approval, the Postal Service hopes that the Commission will grant its approval without limitation. Doing so would assist Discover in its long-term planning. The Commission's approval would also send a clear signal to other financial industry mailers that mail remains a viable and robust medium for marketing in the digital age as Discover, one of the industry's leading users of digital media, believes mail is a key component of its diversified, integrated and comprehensive marketing portfolio.

While it is not possible to provide a precise timeline, the minimum time it would take to assess the minimum data necessary to evaluate the effectiveness of the Agreement would be twelve (12) calendar months after the Commission granted its approval. After that period of time, an additional 60-90 days would be required to sort, review and validate the data in order to make an informed determination.

As noted in our response to Question 4, in the event the Agreement fails to either reduce Postal Service costs or increase the overall contribution to our institutional costs, the Postal Service expects that circumstances would lead to a decision to terminate the

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Agreement. The recommendation would not be based solely on materials provided to the Commission but would include other factors such as economic and market conditions.

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QUESTION 9: As a result of this Agreement, does the Postal Service foresee Discover mail volume migrating from a mail category with a relatively low cost coverage to a mail category with a relatively higher cost coverage (e.g., "Letters" to "High Density & Saturation Letters")? Please explain.

RESPONSE 9: The Postal Service does not foresee Discover's mail volume migrating from a mail category with a relatively low cost coverage to a mail category with a relatively higher cost coverage. As a pre-condition for Discover (or any other company) to undertake such a migration, there must be sufficient carrier route density and sufficient concentrations of users in target carrier routes. This is also a business decision which a company would factor into its overall marketing strategy. It is not something which could occur overnight, as it would require considerable thought, coordination and reprogramming.

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QUESTION 10: As a result of this Agreement, does the Postal Service foresee Discover increasing its “prospecting” volume?⁶ To the best of the Postal Service’s knowledge and belief, does Discover send mail to its current customers at a higher frequency than it mails to its prospective customers? Please explain.

RESPONSE 10: Whether Discover increases its “prospecting” volume is a question which is subject to changing market conditions, business imperatives, and Discover’s marketing strategy. While the Postal Service hopes that Discover would increase its total “prospecting” mail volume, without Discover disclosing its proprietary business decisions as they occur (something which is not within our purview), we cannot with any certainty state when, if and to what extent such efforts would be undertaken by Discover. We do not have information regarding the frequency Discover sends mail to its current customers or to its prospective customers.

⁶ “Prospecting volume” is volume sent to prospective customers, with the expectation that some prospects will become Discover’s customers.

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QUESTION 11: In the workbook "DFS Appendix," the Postal Service assumes that the exigent surcharge will be removed during contract year 2.

- a. Please confirm that the Postal Service estimates that, absent the implementation of the Agreement, Discover's volumes will continue to decline during contract year 2 despite a real price decrease of 4.3 percent. If not confirmed, please explain.**
- b. Please confirm that if the Agreement is implemented, the Postal Service estimates that the 2.5 percent price decrease will incentivize over 255 million pieces of Standard Mail in contract year 2. If not confirmed, please explain.**
- c. Please provide additional analysis to support the Postal Service's estimation that a 2.5 percent price decrease will lead to increased volume, while a 4.3 percent price decrease will lead to a decrease in mail volume.**

RESPONSE 11:

- a. The Postal Service confirms its good faith estimates that Discover's volumes will continue to decline during contract year 2, absent the implementation of the Agreement. Absent the Agreement, Discover stated it would shift its marketing dollars from mail to digital. It is not clear whether the removal of the exigent surcharge would have any effect on that decision. Furthermore, there is no causal connection between the anticipated 4.3 percent exigent rate decrease and Discover's decision to shift marketing dollars absent the Agreement.
- b. The Postal Service confirms its good faith estimates that the price decrease will incentivize Discover to increase overall contribution. Discover's decision is unrelated to "incentivizing over 255 million pieces of mail". Discover made a business decision to maintain its mail spend at current levels and to increase it to the level where it would

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qualify for a rebate under the NSA. The rebate is not an incentive per piece. It is a percentage rebate on the aggregate gross annual revenue.

c. It should be noted that the objective of the Agreement is to achieve incremental growth, not a specific level of growth. Under the NSA, Discover gains no advantage unless and until it (i) meets or exceeds the specified annual revenue thresholds and (ii) exceeds the aggregate total volume for DFS Eligible Mail. In the Postal Service's view, Discover would not have agreed to volume and revenue thresholds and non-performance penalties, unless it fully intended to faithfully perform as required under the NSA in order to receive the benefits mutually negotiated. We agree that a 4.3 percent price decrease, unrelated to the Agreement, would mitigate Discover's volume decline. It would not; however, eliminate the competition with digital media that will influence the trend toward declining volume generally, and it would not obviate the objective of this NSA to induce Discover to maintain, and even grow, its mail usage. Rather than a price decrease that would "lead to" a volume decrease, the volume decrease is anticipated based on other factors, the cumulative effects of which must be greater than the volume-inducing effects of a 4.3 percent price decrease.

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QUESTION 12: in Docket No. R2013-11, the Postal Service used its roll forward model to estimate volume change due to the proposed price increases. The following table details how the Postal Service estimated that the CPI price change of Docket No. R2013-10 would impact Standard Mail (as a class) and Standard Mail Letters volume.

	2014 BR Forecast (Millions)	2014 AR Forecast (Millions)	Change in Volume (Millions)
All Standard Mail	81,856	81,395	-462
Standard Mail Letters	48,432	48,164	-268

In this docket, the Postal Service estimates that providing Discover a 2.5 percent price decrease in contract year 3 will incentivize over 300 million pieces of additional Standard Mail, an increase of 41 percent. In Docket No. R2013-11, the Postal Service estimated that increasing prices for all standard mailers by 1.6 percent would decrease volume by 462 million pieces, a 0.56 percent decrease in volume. Further, the Postal Service estimated that increasing prices for all Standard Mail Letter mailers by 1.6 percent would decrease volume from 48.3 billion pieces to 48.1 billion pieces. Please explain why the Postal Service believes that Discover's response to price changes diverges dramatically from that of other Standard mailers. Please include data gathered during the prior Discover negotiated service agreement that supports this belief.

RESPONSE 12:

There is no inconsistency between the positions taken in Docket No. R2013-11 and the present Agreement. This NSA is designed to slow the decline in volume of Discover's mail. Absent this Agreement, the decline in Discover's mail volume would accelerate.

Although models may be useful for estimating volume change resulting from proposed price increases on an aggregate basis, they are not particularly useful when applied to individual mailers. It is not accurate to say that a 2.5 percent price decrease would incentivize spending by Discover which would result in 300 million mailpieces. It is

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more accurate to say that giving Discover a 2.5 percent rebate if it (i) meets or exceeds the specified annual revenue thresholds and (ii) exceeds the aggregate total volume for DFS Eligible Mail would preserve Discover's current aggregate mail spend and increase its contribution necessary to qualify for the negotiated rebate levels.

Discover's response to price change differs from that of other mailers. This is also true for any individual mailer as each mailer's response to a price change differs from the average, because each mailer represents an individual data point. Moreover, Discover is a multi-channel marketer with many effective digital options to mail because of its digital expertise. Because Discover is a direct and digital bank, they are technology-focused and rely heavily upon information technology ("IT"). Like an IT company, Discover has a much higher IT comfort zone than many companies. Thus, they are able to take advantage of the services of companies that compete with the Postal Service in a way that many companies cannot.

The premise of this question is incorrect. The Commission is attributing a belief to the Postal Service which it does not hold. Although the Postal Service does not believe that Discover diverges dramatically from other Standard Mail mailers, we do believe Discover differs from them for the reasons described by Harit Talwar. Mailers of large volumes of letter-shape mail⁷ such as Discover have different mail preferences, unique

⁷ There are different prices and different standards for preparing mail depending on the size of the mailpieces. Mailers can create mailpieces with their own special envelopes or design pieces that will be folded to letter-size. The Postal Service charges extra postage for custom mailpieces that are rigid,

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requirements and distinctly different business models and marketing needs. While the Postal Service is uncertain what constitutes a “dramatic divergence”, it recognizes that each mailer is uniquely different from the other mailers within a given industry sector.

square, or unusually shaped. See Business Mail 101, Sizes for Letter, U.S. Postal Service © 2014, available at <http://pe.usps.com/businessmail101/mailcharacteristics/letters.htm>.

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QUESTION 13: Figure 1 shows Discover's Standard Mail Regular Letter monthly volume for fiscal year FY 2013 and FY 2014. During FY 2013, the previous negotiated service agreement (NSA) was in effect. During FY 2014, the NSA was in effect for the first 6 months. As Figure 1 illustrates, from March through September, the FY 2013 volumes exceed the FY 2014 volumes for all months except June.

Figure 1

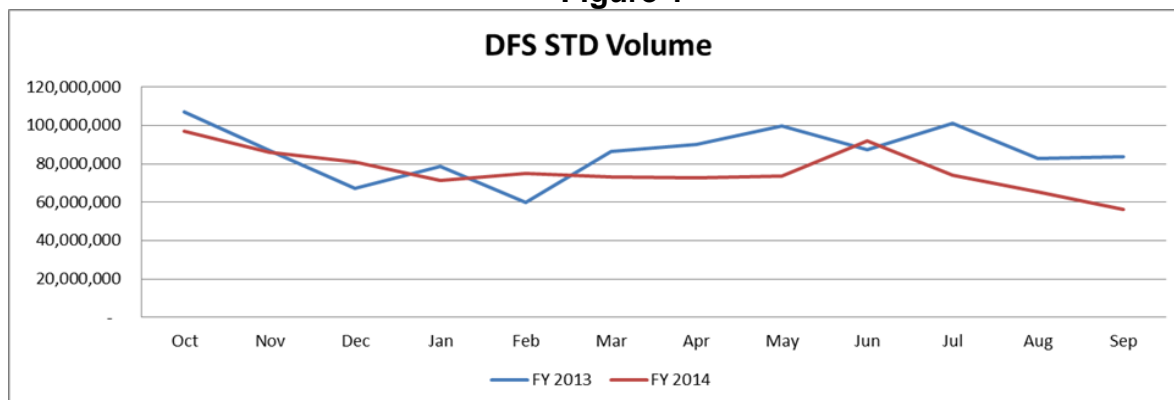


Figure 2 shows the year-to-date (YTD) volume of Discover's Standard Mail Regular Letters for FY 2013 and FY 2014. This reflects the cumulative amount of Discover mail from October through September.

Figure 2

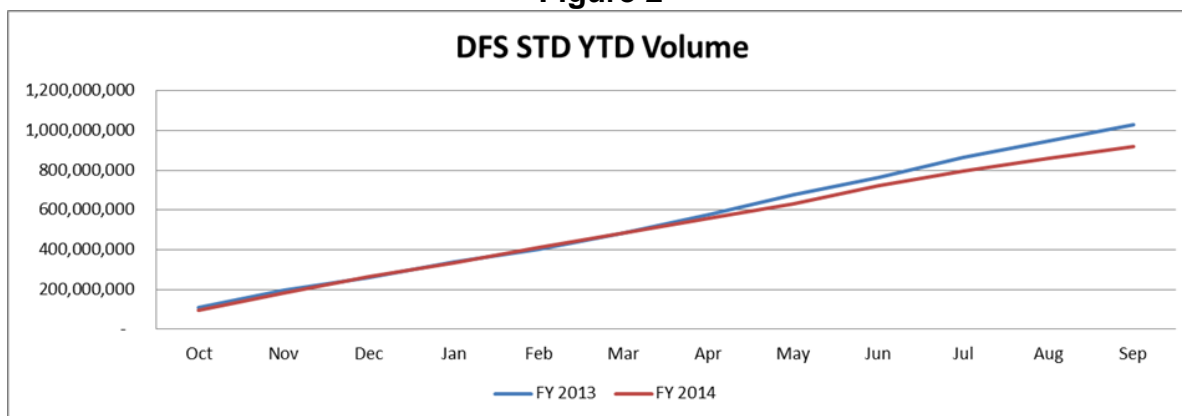


Figure 2 presents the cumulative volume. It appears that in the first 6 months of FY 2013 and FY 2014 it follows the same path. The termination of the NSA at the end of March 2014 appears to cause the slope to decrease, as compared with the FY 2013 slope. The exigency price increase may also have affected the change in

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slope. The two figures may provide a basis for estimating own-price elasticities for Discover.

- a. Please provide an elasticity estimate for Discover First-Class and Standard Mail supported by quantitative analysis and based on historical volume data. Please include a discussion of how the analysis accounts for the effects of other factors like the exigency price increase, volume increases when prices are constant,⁸ general economic conditions, and other relevant non-price factors.**
- b. Please provide an analysis of the net value of the Agreement using the accepted methodology and the elasticities derived in part a. of this question.**

RESPONSE 13:

a. Elasticities calculated in response to this request are provided in the spreadsheet filed herewith (see CIR No.1 QU13.xlsx, Tab 13.a – Response). The calculated elasticities were derived from historical changes due to price decreases in the form of expected rebates and volume growth which are further described in the aforementioned spreadsheet.⁹ Unless and until Discover (i) meets or exceeds the specified annual revenue thresholds and (ii) exceeds the aggregate total volume for DFS Eligible Mail¹⁰ for each corresponding contract year during the term of this Agreement, Discover must pay the Postal Service the published rates. Since the exigent surcharge is part of the published rates, the rebate (if and when it is earned) becomes a discount off the published rates in addition to the exigent increase.

⁸ See, e.g., Docket ACR2012, Annual Compliance Determination Report, May 7, 2013, at 154-55 (Commission reports Discover increased volume by 236 million pieces prior to the implementation of the NSA).

⁹ It should be noted that the contract year is a twelve-month period. As such, it may not coincide with a single fiscal year or a single calendar year.

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Volume growth under the Agreement is realized to the extent that, among other things, general economic conditions in the U.S. improve or deteriorate, the U.S. economy expands or contracts, and non-price factors influence Discover to change current mail usage into the future.

b. Although the Postal Service made a good faith estimate of Discover's implied elasticity, the Postal Service did not rely on this elasticity to estimate the value of the Agreement.¹¹ In the Postal Service's view, it would be misleading to provide such an estimate, since it would not reflect the decision-making process that led to the agreement with Discover. That process relied on honest negotiations between the two parties involving the interplay of each party's objectives, and in light of each party's internal and external influences and constraints. While a basic methodology, such as that employed by the Commission as a tool to evaluate NSAs, might be useful to add perspective to its review, it cannot substitute for the business judgment of the two parties in negotiating the agreement. In evaluating the legal sufficiency of the agreement, the Postal Service honestly concluded that the value of the deal with Discover met all applicable legal standards. In addition, as a practical matter, if the Postal Service were simplistically to apply an implied elasticity to decide the outcome of its negotiations, it would have to develop a formula relying on assumptions concerning Discover's business judgment, which are not readily

¹⁰See Articles II.C & D of the Agreement.

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knowable, and which Discover would regard as highly sensitive commercially. The complexity of Discover's determinations in this regard is illuminated by Mr. Tawar's description. In this context, in particular, the trend lines referred to in the question provide no basis to take account of the emergence of digital marketing and Discover's reaction to it in making decisions on whether and how much to mail.¹²

¹¹ For a further description using the Commission's preferred methodology, please see the spreadsheet filed herewith (see Tab 13.b – Response).

¹² "IAB internet advertising revenue report - 2013 full year results", Interactive Advertising Bureau (Apr. 2014), *available at* http://www.iab.net/media/file/IAB_Internet_Advertising_Revenue_Report_FY_2013.pdf.

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QUESTION 14: In CHIR Response, question 3, the Postal Service states that it relies on “marketing intelligence, customer-specific information furnished to us by the customer (as in the case of Discover), and past history (again provided by Discover in relation to their prior NSA)” to determine the net value of the Agreement.

- a. Please explain how the Postal Service evaluates the quality of the data furnished by Discover.
- b. Please provide the customer-specific information provided by Discover.
- c. Please provide any internally-produced reports, analyses, etc. that the Postal Service relied upon in its estimates of before- and after-rates volume.
- d. Please provide any data from any sources not a party to this Agreement that the Postal Service relied upon in its estimates of before- and after-rates volume.

RESPONSE 14:

- a. The Postal Service relies on postal data informed by customer data. The Postal Service considers the data furnished by any customer as reasonably reliable subject to verification as necessary.
- b. The after-rates information received from Discover was provided orally during the course of negotiations. Due to its proprietary and sensitive nature, all written materials reside with Discover.
- c. The specified annual revenue thresholds and the aggregate total volume trigger the rebate. The internally-produced reports, analyses, etc. that the Postal Service relied upon in its good faith estimates of before- rates volume are detailed in our response to Question 7 above and in Financial Industry Summaries spreadsheet submitted herewith. Please be advised that after-rates information is not developed

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by the Postal Service, it is provided by our customers. As noted in our response to Question 6 above, the after-rates volumes were the result of negotiations with Discover and represent the mutually agreed upon thresholds at which trigger the negotiated rebates. For a description of after-rates information, please see our response to Question 14.b above. d. The non-party data relied upon by the Postal Service in its good faith estimates of before-and after-rates volume is detailed below.

- Marketing Fact Pack – Annual Guide to Marketing, Media and Agencies, 2014 Ed., Advertising Age, Crain Communications and The Ad Age Group (Dec. 30, 2013), *available at* http://gaia.adage.com/images/bin/pdf/MFPweb_spreadsv2.pdf
- IAB/PwC: “IAB internet advertising revenue report - 2013 full year results”, Interactive Advertising Bureau (Apr. 2014), *available at* http://www.iab.net/media/file/IAB_Internet_Advertising_Revenue_Report_FY_2013.pdf

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QUESTION 15: In CHIR Response, question 3.c., the Postal Service contends that the subclass elasticity “includes mailers from such diverse industries as cataloguers, retail stores, Direct Mail sales and financial institutions.” It asserts that to “use the class elasticity implies that all these industries react to price changes identically.”

- a. Please list specific reasons why Discover has a higher price elasticity (in absolute terms) than the mailers within its subclass.
- b. Please provide quantitative evidence that Discover’s elasticity deviates significantly from the subclass average.
- c. Does the Postal Service believe that other large financial institutions have similar elasticities to that of Discover? Please explain.
- d. What group or groups of mailers of Standard Mail have elasticities significantly below the average in absolute terms? Please explain the rationale for your response.
- e. Does an NSA, which contains volume and revenue thresholds affecting the eligibility for discounts, cause the contract partner’s own-price response to be different from its typical own-price response to general price changes for postal products? Please explain the rationale for the response.

RESPONSE 15:

- a. For the specific reasons why Discover has a higher price elasticity (in absolute terms) than the mailers within its subclass, please see the statement of Harit Talwar.¹³ Because of its digital experience, expertise, and success in the area of marketing, Standard Mail is not a monopoly product for Discover. Discover operates in a highly competitive market that includes a wide variety of targeted digital channels. As Harit Talwar stated, “. . . digital companies such as Google®, Yahoo®, and other search engine companies, as well as scores of digital marketing companies regularly come to us with presentations about how to use them more

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effectively and they offer packages to do so at a lower cost. Discover has many choices, and their number and effectiveness grow every year. This was not true a decade ago.”¹⁴

b. The quantitative evidence that Discover's elasticity deviates significantly from the subclass average is shown in the prior NSA period where Discover's volumes varied significantly from what the class elasticity would have predicted. The Postal Service does not measure how elasticities differ by customer. As the Commission is well aware, the Postal Service's elasticity measures are a composite of many customers; each of which may react to price changes differently. The Postal Service does not believe that it would be feasible to collect data from Discover that would enable it to isolate the effect of non-price variables from the effect of price changes. The rationale for Discover's decision to use the direct mail marketing channel, rather than one of the competing marketing channels, is a proprietary decision outside our purview.

c. In its business judgment, the Postal Service believes that other large financial institutions have similar elasticities to that of Discover to the extent that complex marketing decisions can be distilled down to a price elasticity. With respect to the complex processes and business considerations involved in developing tactical and strategic marketing strategies which drive corporate media channel buying

¹³ Talwar Statement, *supra* at 3.

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decisions, relying on price elasticity is too simplistic.¹⁵ How other financial institutions react to price, and whether they would act similarly to Discover would depend in part upon how digitally sophisticated they were, and how much experience they had with digital marketing channels. While Discover and other large financial institutions may have similar elasticities, each customer is unique and behaves in different ways to produce an average.

d. Although the Postal Service does not have and did not rely on a list of Standard Mail mailers with significantly below average elasticities, it is logical that the group(s) of mailers of Standard Mail which have elasticities significantly below the average (in absolute terms) include those industries which do not do a significant portion of their advertising through alternative media. For example, mailers that are not digitally sophisticated cannot easily take advantage of the services that the Postal Service's digital competitors offer. Nonetheless, even digitally sophisticated mailers may elect not to rely on digital marketing for a variety of reasons (e.g., their customers enjoy the privacy, security and trustworthiness of mail; the response quality; the likelihood the customer may read and respond, etc.).

e. While company behaviors change due to market, economic and other factors (e.g., changes in management and business strategy), for a description of the effect

¹⁴ Id. at 3.

¹⁵ Conceptually, elasticity may be better suited to commodity products in a monopoly environment an advertising medium such as mail.

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an NSA containing volume and revenue thresholds affecting the eligibility for discounts would have on Discover's own-price response to general price changes for postal products, please see Harit Talwar's statement. Moreover, as NSAs approved by the Commission offer postal clients such as Discover a degree of financial certainty, mailers like Discover can rely on an NSA for planning and budgetary purposes.

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QUESTION 16: The Postal Service states that it “negotiated and evaluated this NSA based on its best business judgment of Discover’s future behavior, given current trends, understanding of Discover’s business, and expectations of market and economic conditions, and will evaluate actual results based on these same factors.” Response to PR at 5.

- a. Please provide the analysis of current trends relied upon by the Postal Service.**
- b. Please describe the aspects of Discover’s business the Postal Service considered in evaluating this Agreement and how the Postal Service’s understanding of Discover’s business factored into the evaluation.**
- c. Please describe the Postal Service’s expectations of market and economic conditions as related to the Agreement.**

RESPONSE 16:

- a. The Postal Service considered current First-Class and Standard mail trends for other companies in the financial services sector as well as broader marketplace trends in media channel selection and performance. For more detailed information, please see our responses to Questions, 6, 7 and 14 above.
- b. The aspects of Discover’s business the Postal Service considered in evaluating this Agreement include keeping the mail as a key component of Discover’s multichannel marketing mix in the face of significant competition from other media as well as the evolution of performance by competing media. For more detailed information regarding the Postal Service’s understanding of Discover’s business factored into the evaluation, please see our responses to Questions 6, 7 and 14 above.

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c. The Postal Service's expectations of market and economic conditions as related to the Agreement are that (1) the mail will face increasingly tough competition from other advertising media which offer greater pricing flexibility in both absolute dollar terms and the pricing structure (i.e., performance-based pricing) and (2) competing media in the electronic realm continue to refine targeting techniques to produce improved results. In addition to these factors, the evolving generational communications preferences compound the problems faced by hard-copy mail as it competes for consumer attention in a screen-focused world. On the customer side, these same electronic advances are threatening the traditional credit card as a payment vehicle as consumers adopt methods like PayPal® and ApplePay® as new ways to transact business. All of these factors paint an uncertain future for the viability of the mail as an advertising medium – a future that the Postal Service is striving to solidify through this NSA.

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QUESTION 17: The Postal Service's after-rates forecasts for Discover's volume in year 1, year 2, and year 3 of the previous NSA was off by 7.1 percent, 6.5 percent and -8.0 percent, respectively. In addition, based on the 8 prior NSAs, the Postal Service's volume projections in years 1, 2, and 3 were off by 7.7 percent, 14.0 percent, and 24.2 percent, respectively.

- a. What factors contributed to the inaccuracy of these forecasts?**
- b. What steps has the Postal Service taken to ensure more accurate forecasts for the Agreement?**

RESPONSE 17:

Please note that there have only been three (3) market-dominant NSAs since the enactment of the Postal Accountability and Enhancement Act ("PAEA")¹⁶ in 2006. As the focus of the Commission is on the accuracy of our estimates for the prior Discover NSAs, our response will focus on those forecasts.

- a. While hindsight is always 20:20, forecasts are good faith estimates which are subject to changes which occur well after those estimates are made. Even with the latest technology and most sophisticated models, they remain educated guesses. Thus, unforeseen events such as the emergence of disruptive new technologies, the impact of litigation or legislation on stock prices, contractions in the domestic and/or global economies, natural disasters, etc. can positively or negatively impact performance.

¹⁶ Postal Accountability and Enhancement Act of 2006, Pub. L. 109-435.

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When a company makes financial and other planning projections, it does so with the understanding that those projections are subject to change. For example, as budget changes happen over time, a company's original projections could easily be off by 7 percent or more six months after they were made because the facts and circumstances have changed. For example, airlines buy fuel in bulk based on projected prices. An unexpected development such as the oil market collapsing and oil falling to under \$20 per barrel could render projections made just weeks before obsolete and off-target. The Postal Service does not expect that it can do better than its corporate peers, and the accuracy of its forecasting should not be held to a higher standard by the Commission in evaluating after-rates forecasts than its corporate customers and competitors.

b. The Postal Service conducts regular in-service training and also conducts regular reviews to ensure the accuracy of our information.

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QUESTION 18: The Postal Service states that the “NSA is designed to minimize risk in an unstable market environment.” Response to PR at 3. It concurs with the Public Representative’s suggestion that it is “acting logically by trading risk for certainty.” *Id.*

- a. Please explain how the minimization of risk may improve the net financial position of the Postal Service.**
- b. Please quantify any benefit discussed in part a. and provide quantitative evidence supporting this estimate.**

RESPONSE 18:

a. The more risks a company faces, the greater the chances of failure. This is because the more risk a company faces, the greater the chances of instability. The greater the instability, the greater the chances are that customers will see a company as an unreliable business partner and the more likely it is that they will turn to its competitors, even if those competitors offers higher prices. The more customers that leave an unstable business partner for its competitors, the greater the chances of enterprise failure. Thus, minimizing risk is critical to business success. Given the nature of risk and the necessity of minimizing it, by entering into an NSA with Discover, the Postal Service minimized the risk of losing significant revenue from Discover by keeping it in the mail instead of Discover diverting its funds to digital media.

b. As indicated in Discover’s submissions to the Commission, by keeping over \$300 million dollars a year in the mail for each of the next three (3) years, the NSA should improve the net financial position of the Postal Service. This NSA helps ensure the

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financial stability of the Postal Service by contributing nearly \$1.0 billion in total revenues over its three-year term.